

Australia's proposed Minerals Resource Rent Tax

Much achieved but a long way to go

"Whilst the proposals represent key principles, they require extensive design and analysis before implementation. It is critical that the many affected parties are involved in the consultation process"

Craig Robson, Oceania Tax Leader, Ernst & Young

On 2 July 2010, Prime Minister Julia Gillard, Treasurer Wayne Swan and Resources Minister Martin Ferguson announced a new resources tax proposal after consultation with segments of the resources industry.

The Government has abandoned the "catch all" Resource Super Profits Tax (RSPT) and proposes a new profits tax applicable to the coal and iron ore sectors, to be known as the Minerals Resource Rent Tax (MRRT). The proposed narrowing of affected resources will reduce the number of affected taxpayers from over 2,000 to 320 companies.

Under the proposal, the existing Petroleum Resource Rent Tax (PRRT) is to be expanded to include onshore oil and gas projects, including coal seam gas projects and the North West Shelf.

The MRRT proposed tax rate is now 22.5%. This rate is a combination of:

- ▶ 30% headline rate, down from the previous 40%
- ▶ A further 25% extraction allowance against the gross MRRT liability for all affected companies "to further shield from tax the important know-how and capital that mining companies bring to mineral extraction"

The proposal represents not much more than key principles at this stage, they require extensive design and analysis before implementation. We recommend that impacted resource companies provide input to the policy transition processes.

The new proposal results in a reduction in tax revenue. Accordingly, the Government proposes to eliminate the previously announced resource exploration rebate, remove the refundability of losses and State royalties, and to limit the planned company tax rate reduction to 29%.

Overview

Any new tax such as the proposed MRRT and expansion of PRRT affects Australia's competitiveness, and the capital allocation decisions of global and Australian resource companies. This modified proposal will need detailed analysis by resource companies and investors in Australia and globally to consider its impact on new investment proposals.

It is positive that the Government and major industry participants have reached, in principle, broad agreement given the public debate that followed the original announcement of RSPT.

In response to industry concerns about increased sovereign risk, the Government has allowed a choice of market value or book value as the starting value for existing projects.

We welcome the ability to write off new capital expenditure incurred from 1 July 2012 up-front under the MRRT, aligning it to the PRRT.

The uplift rate for undeducted expenditure under the MRRT is proposed to be the long term bond rate (LTBR) plus a 7% p.a. loading. However, the MRRT is still to be based on project profits before interest expense, so debt-funded miners will need to consider the implications of debt financing affected projects.

The Government has scrapped the proposal for refunds in relation to the closure of loss-making projects. This may impact junior explorers and companies with a single project.

The de minimis rule is positive, excluding those businesses with MRRT assessable profits of less than \$50 million per annum from the MRRT. There is limited detail at this stage as to how this exclusion will apply and it will be important for junior miners to be involved in the development of this policy measure.

The on-shore oil and gas industry will transition into the PRRT regime with its continuing 40% tax rate. Projects transitioning into this regime can adopt either a market value or written down book value. There is limited detail in the Government announcement on this transition.

We also welcome the establishment of the consultation process, through the Policy Transition Group. This will allow affected businesses to have a say on the future design of the detail of these arrangements.

Action required

The proposed MRRT is likely to be a complex tax. It is not yet fully developed and is open to consultation. There is the potential for differing outcomes depending on individual circumstances.

We recommend all iron ore and coal companies assess the impact of MRRT on their enterprise value and understand the detailed aspects of the tax. It is critical for affected businesses to provide strong input to the policy development process, as there are many unresolved issues.

All impacted companies will also want to model the different outcomes that could arise depending on whether a book value or market value starting base is adopted.

Iron and coal companies will look to the Policy Transition Group and Government to issue further guidance on key issues. For example:

- ▶ Whilst we welcome the Government's intention to tax iron ore and coal as close to the point of extraction as practicable, the detail around the calculation at the taxing point will be complex and has the potential to have very different outcomes for different projects
- ▶ It is unclear whether the LTBR plus 7% uplift factor will apply to expenditure incurred by companies between the announcement date 1 May 2010 and the implementation date 1 July 2012
- ▶ The Government needs to confirm that all state royalties, including future increases, will be creditable against the MRRT

Companies making capital allocation decisions need to model and factor in the future impact of MRRT. Companies anticipating exploration rebates or RSPT recoveries need to adjust their plans accordingly.

Companies which have made disclosures under continuous disclosure requirements need to consider their further obligations.

"This announcement provides an increased level of certainty for the resource sector."

Mike Elliott, Global Mining & Metals Leader, Ernst & Young

The MRRT will be a complex tax requiring multi-layered calculations and valuation processes.

The Government announcement and fact sheet can be accessed as follows - http://www.futuretax.gov.au/documents/attachments/factsheet_resource_taxation.pdf

We provide some further detail on the proposals below.

Analysis of the MRRT

We summarise the MRRT and compare it to the RSPT as follows:

Item	RSPT	MRRT
Headline tax rate	40%	22.5% MRRT Tax Rate calculated as: 30% MRRT Rate LESS: 25% Extraction Allowance (30% MRRT rate x 25% extraction allowance = 7.5% overall reduction)
Starting base	Equal to the accounting book value of existing project assets as at the most recent audited accounts available at 2 May 2010 (excluding the value of the resource)	Choice of: 1. Market value of existing investment (including value of resource) - depreciated over effective life capped at 25 years (no uplift); or 2. Book written down value of project assets (excluding the value of the resource) depreciated at accelerated rates over 5 years (uplift at Capital Uplift Rate available). Unclear whether book value is determined at 30 June 2012.
Capital uplift rate for capital expenditure and unutilised losses	10 year LTBR uplift rate	10 year LTBR + 7%
Credit for State Royalties	Refundable credit for State royalties at least up to rates as at 2 May 2010 with scheduled increases	Credit for State royalties paid. Unused credits for State royalties will be carried forward and uplifted at the capital uplift rate above. Unused royalty credits will not be transferable or refundable.
Is all capital expenditure recouped before first tax payable?	No	Yes and No. Pre 1 July 2012 Capital Expenditure - No Post 1 July 2012 Capital Expenditure - Yes
Expenditure transferability	Undeducted expenditure is transferable, other than RSPT starting base	MRRT will allow transferability of deduction
Refundability of undeducted expenditure on project cessation	Refundability of 40% unutilised expenditure on project cessation	No refund available
Taxing point	Subject to negotiation	As close to the point of extraction as practicable, using appropriate pricing arrangements to ensure only the value of the resource is taxed.

What projects are in and out of the MRRT and PRRT?

It is proposed that the MRRT and PRRT only apply to iron ore, coal, oil and gas.

This is welcome news for industries such as gold, uranium, nickel, bauxite, clay and numerous other commodities.

It is unclear whether brown coal intended for energy production will be subject to the MRRT.

MRRT rate, royalties and abandoned projects

The MRRT will be imposed at 30%, reduced by a 25% extraction allowance. This will result in a net MRRT tax rate of 22.5%.

Credits will be allowed for State royalties paid. There is no mention of the credit limited to royalty levels at 2 May 2010, as was previously announced with RSPT.

The Government has also scrapped the proposed refundability of State royalties. Unused royalty credits are carried forward and uplifted at the Capital Uplift Rate for future offset against MRRT.

A refund is not available for undeducted expenditure and royalty credits on project cessation. Undeducted expenditure will be transferable amongst MRRT projects carried on by the same taxpayer, however unused royalty credits will not be transferable.

This effectively means that the State royalty regime will be the annual base-line tax impost, with the MRRT being imposed only once all allowed expenditure (including State royalties) has been recouped.

Starting base

The starting base is outlined in an overall sense but with very little detail. Affected miners will have two options.

1. To use the book value (excluding the value of mining rights) as the starting base for project assets, with depreciation accelerated over five years. A book value starting base will be uplifted at the LTBR+7%.
2. To use the market value starting base as at 1 May 2010 for project assets, including the value of mining rights, with depreciation over the effective life (up to 25 years). A market value starting base will not be uplifted.

Capital expenditure between 2 May 2010 and 30 June 2012 will be added to the starting base.

Taxing point

The Government has announced its intention to tax iron ore and coal as close to the point of extraction as practicable (using a mine gate concept). The detail around the calculation at the taxing point will be complex and has the potential to have very different outcomes for different projects. Producers with beneficiation processes and significant infrastructure which add high value will need to ensure the proposed rules for identifying the taxing point do not unfairly prejudice these projects. Engagement with the Policy Transition Group will be critical.

"These MRRT measures and expansion of PRRT are significantly different to the catch-all RSPT and it will be important to analyse these new measures in detail."

**Chad Dixon, Partner - Tax,
Ernst & Young**

Impact for junior miners

Junior miners which do not have multiple projects or strong income flows will need to consider the adjusted proposals in detail.

The proposed resource exploration rebate is to be withdrawn. This was aimed at small listed exploration companies and proposed as an incentive for exploration and prospecting activity. Although this incentive has been withdrawn, the Government announced that the Policy Transition Group will consider ways to encourage future exploration.

Implications for financing of mining projects

The MRRT retains the exclusion of financing costs from the allowable costs and allows the indexation of capital expenditure at the LTBR + 7%. This trade-off will mean that companies involved in developing coal or iron ore projects will need to carefully consider the financial impact of decisions such as owner operating mines versus outsourcing of mining services.

Detailed design and implementation issues to consider

There are a number of issues to be addressed in implementing these new tax measures. These issues include:

- ▶ The MRRT proposes to adopt the same categories of non deductible expenditure as the PRRT. Under the PRRT, non-deductible expenditure includes interest deductions, acquisition costs and certain indirectly incurred administrative expenditure. Uncertainty remains as to these categories of expenditure, for more information, please go to [http://www.ey.com/Publication/vwLUAssets/Pub -
_Petroleum_Resource_Rent_Tax/\\$FILE/TAX_Pub_Petroleum_Resource_Rent_Tax.pdf](http://www.ey.com/Publication/vwLUAssets/Pub_-_Petroleum_Resource_Rent_Tax/$FILE/TAX_Pub_Petroleum_Resource_Rent_Tax.pdf)
- ▶ The proposals do not specifically deal with the impact on acquisition transactions under this new regime and this will require clarification.

Companies will need to assess the impact of the proposed MRRT on:

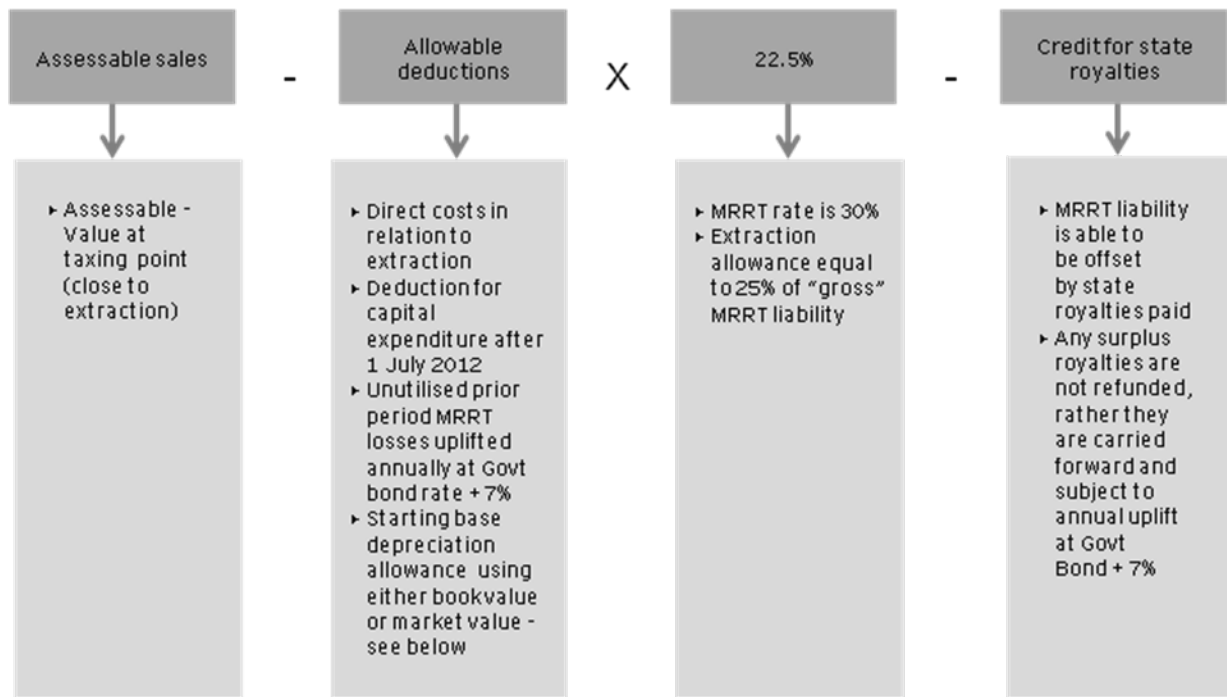
- ▶ Structuring of joint venture arrangements
- ▶ Deferred tax accounting for these taxes and transitional base
- ▶ Interaction with double tax treaties and creditability of MRRT
- ▶ The impact of hedging arrangements
- ▶ Whether a functional currency other than Australian Dollars can be adopted
- ▶ The financing of key infrastructure and operating assets

“The appointment of Mr Don Argus as co-chair with Resources Minister Martin Ferguson of the Policy Transition group, to include "credible respected industry leaders", will build business confidence in the governance and quality of the policy development and delivery through the election and beyond.”

Andrew van Dinter, Partner - Tax, Ernst & Young

Calculating the proposed Minerals Resource Rent Tax

Iron ore and coal producers with resource profits exceeding \$50m per annum



- Market value starting base (deductible over less of 25 years or effective life)**
- Market value at 1 May 2010 of project assets including mining rights, with no annual uplift of undeducted balance
 - Capital expenditure between 1 May 2010 and 30 June 2012
- Book value starting base (deductible over 5 years using accelerated rates)**
- Book value of project assets excluding mining rights at 30 June 2012 (clarification required)
 - Undeducted balance uplifted annually at Govt bond rate + 7%

Government claw back of broader beneficial business tax reforms

Given the reduction in the forecast tax revenue under the new proposal compared to that under the original RSPT, the Government has revised some of the other proposed tax reforms announced on 2 May 2010 in response to the Review of Australia's Future Tax System. We summarise the changes below.

Company tax rate to be cut to 29% not 28%

The existing 30% company tax rate will continue to be cut to 29% from 2013-14 but will not be further reduced under current fiscal conditions. At this stage the Government proposes not to proceed with the previously announced rate cut to 28%.

Small companies will however benefit from an early cut to the company tax rate to 29% from 2012-13 as follows.

	Company tax rate Income year 2012	Income year 2013	Income year 2014 +
Small companies	30%	29%	29%
Other companies	30%	30%	29%

Superannuation guarantee increases to remain

The Government will proceed with its proposed gradual increase in the superannuation guarantee charge from 9% to 12%.

Resource exploration rebate will not be pursued

The Government will not proceed with the previously announced resource exploration rebate for Australian based exploration incurred on or after 1 July 2011.

Infrastructure fund is expected to remain

The Government's proposed funding of resource-related infrastructure projects is expected to occur through the new \$6 billion regional infrastructure fund.

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